The ECJ in “Estro/Smallstep” on the Dutch pre-pack in relation to article 5(1) of Directive 2001/23

A red flag for the pre-pack as we know it?

In its preliminary ruling of today, the ECJ has decided that the Dutch pre-pack does not come under the derogation in Article 5(1) of Directive 2001/23. The reasoning of the ECJ will have important consequences for the pre-pack-practice and (draft) legislation in all European Member States, including Belgium, Germany, France and the United Kingdom.

Background: Project Butterfly

In November 2013, Estro Groep BV (with 380 establishments and 3.600 employees the largest childcare company in the Netherlands) entered into financial distress. Since plan A, *i.e.* consulting its lenders and principal shareholders in order to obtain further financing, was unsuccessful, “Project Butterfly” came into force. Under Project Butterfly, a significant part of Estro Group would be transferred pursuant to a pre-pack: 243 centers out of 380 would be saved and 2.500 employees out of 3.600 would keep their job.

On 10 June 2014, at the request of Estro Group, a prospective insolvency administrator (“*beoogd curator*”) was appointed by the District Court, Amsterdam (“*Rechtbank Amsterdam*”) to implement Project Butterfly. Whilst implementing Project Butterfly, Estro Groep only contacted H.I.G. Capital, a sister company of its principal shareholder, Bayside Capital, as a potential buyer. No other option was explored. On 20 June 2014, a limited liability company, Smallsteps BV, was created in order to carry out Project Butterfly.

On 5 July 2014, Estro Group was declared insolvent. On that same day (right after the declaration of insolvency), the contract of the pre-packaged insolvency sale (the pre-pack) was signed by the insolvency administrator and Smallsteps. On 7 July 2014, the insolvency administrator dismissed all Estro Group employees. Smallsteps subsequently offered a new contract of employment to nearly 2.600 staff employed by Estro Group.

The Federatie Nederlandse Vakvereniging (“*FNV*”), a Dutch trade union organization, and four joint applicants (dismissed employees), brought an action before the referring court. The District Court, Central Netherlands (*“Rechtbank Midden-Nederland”*) decided to stay the proceedings and to refer to the Court of Justice for a preliminary ruling. The referring court essentially sought to ascertain whether Directive 2001/23 must be applied in the event of a transfer of an undertaking as part of a pre-pack, as has been developed in practice in the Netherlands (second question) and whether, in such a context, the Netherlands

insolvency procedure, and specifically Article 7:666 of the Civil Code ("*Burgerlijk Wetboek*"), as applied in practice, is consistent with the objective and purpose of that directive (first question). By its third question, the referring court is seeking to ascertain whether the reply to those questions must differ depending on whether the main objective of the pre-pack is the continuation of the undertaking and/or maximizing the proceeds of the assignment. Lastly, the referring court raises the question as to exactly when the transfer of the undertaking takes place (fourth question).

The opinion of Advocate General Mengozzi

In his opinion, AG Mengozzi argues that the protection scheme laid down in Articles 3 and 4 of Directive 2001/23 applies to the Dutch pre-pack procedure. In coming to his conclusion, the AG analyzed Article 5(1) of that Directive, which reads as follows:

"Unless Member States provide otherwise, Articles 3 and 4 shall not apply to any transfer of an undertaking, business or part of an undertaking or business where the transferor is the subject of bankruptcy proceedings or any analogous insolvency proceedings which have been instituted with a view to the liquidation of the assets of the transferor and are under the supervision of a competent public authority (which may be an insolvency practioner authorised by a competent public authority)."

I would like to start with two (preliminary) remarks concerning this Article.

First, the Netherlands did not adopt a specific provision which provides "*otherwise*" than in Article 5(1). Therefore, the exception laid down in Article 5(1), which must be interpreted strictly, is relevant in the present case.

Second, Article 5(1) represents the codification of principles laid down in case-law concerning Directive 77/187 (the processor of Directive 2001/23) developed by the Court: ECJ 7 February 1985, no. C-186/83, ECLI:EU:C:1985:58, *Abels* ; ECJ 25 July 1991, no. C-362/89, ECLI:EU:C:1991:326, *d'Urso and Others*; ECJ 7 December 1995, C-472/93, ECLI:EU:C:1995:421, *Spano and Others*; ECJ 12 March 1998, C-319/94, ECLI:EU:C:1998:99, *Dethier Equipement*. In *d'Urso and Others*, the Court expressly stated that *"Given all the considerations set out in the judgement in the Abels Case, the decisive test is therefore the purpose of the procedure in question"* (later affirmed in *Spano and others*). If the *objective* of the procedure is to *liquidate* the debtors' assets in order to satisfy collectively the creditors' claims, then the transfers effected under that procedure are excluded from the scope of Directive 77/187.On the other hand, if the *objective* of that procedure is also to *keep* the undertaking in business, the social and economic objectives thus pursued cannot explain nor justify the circumstance that, when the undertaking is transferred, its employees lose the rights which the directive confers on them. In *Dethier Equipement*, the Court fine-tuned its test: apart from the criterion of the purpose of the procedure, *"account should also be taken of the form of the procedure in question, in particular in so far as it means that the undertaking continues or ceases trading, and also of the objectives of Directive 77/187"*.

As a consequence, the AG finds that exclusion of the Dutch pre-pack procedure from the protection scheme in Articles 3 and 4 of Directive 2001/23 is justified only if the aim of the Dutch pre-pack, having regard to its *objectives* and its *forms*, is the liquidation of the undertaking's assets.

When considering the *objective* of the Dutch pre-pack procedure, the AG finds that there is no doubt that the pre-pack procedure, taken as a whole, is aimed at transferring the undertaking (or its still viable units) in order to *restart* the business without any interruption, immediately after the declaration of insolvency. The declaration of insolvency is in fact used as a means of restarting the undertaking; The pre-pack is merely a "*technical insolvency proceeding*".

When considering the specific *form* of the Dutch pre-pack procedure, the AG finds many differences compared with the "traditional" insolvency procedure. First, the Dutch pre-pack is always initiated by the debtor while an insolvency procedure may be initiated by different stakeholders. Second, the Dutch preparatory phase is entirely informal in nature: (i) the undertaking's management conducts the negotiations and adopts the decisions concerning the sale of the undertaking and (ii) the prospective insolvency administrator and the prospective *juge-commissaire* formally have no powers. In particular, it is clear that the insolvency administrator and the court have much less influence in the case of the "special" procedure leading to the conclusion of a pre-pack than in the case of the "traditional" procedure for insolvency aimed at liquidating the transferors' assets.

In the light of the foregoing analysis, the AG concluded that *"a procedure such as that developed in the Netherlands leading to the conclusion of a pre-pack could not be regarded as a bankruptcy procedure or any analogous insolvency proceedings which have been instituted with a view to the liquidation of the assets of the transferor and as being under the supervision of a competent public authority, for the purposes of Article 5(1) of Directive 2001/23. Consequently, such a procedure does not come under the exception laid down in that provision. It follows that the protection scheme laid down in Articles 3 and 4 of Directive 2001/23 does indeed apply to a transfer of an undertaking, or its still viable parts, as part of such a pre-pack. What follows from the fact that the activity of the undertaking, or of its viable parts, is continued after that transfer, is that it would not be possible to explain or to justify a situation in which the employees of that undertaking, or its transferred units, are deprived of the rights conferred on them by that directive."* As a consequence, the current Dutch pre-pack procedure is not consistent with the Directive 2001/23. It is for the referring court (by means of interpretative methods) to achieve an outcome consistent with the objective pursued by Directive 2001/23.

The opinion of the Court

As we predicted in a previous post, the ECJ has followed the opinion of Advocate General Mengozzi.

When considering the *objective* of the Dutch pre-pack procedure, the ECJ stated that a procedure that prepares a liquidation procedure can be seen as a liquidation

procedure under article 5(1) of the Directive, if – and only if – that procedure also leads to a real liquidation of the company. The real objective of the pre-pack procedure, however, is the preservation of the business. The court explicitly stated that the fact that creditors will receive more under a pre-pack procedure than under a liquidation procedure does not alter the fact that the main goal of the pre-pack procedure is the preservation (and not the liquidation) of the business.

When considering the *form* of the Dutch pre-pack procedure, the ECJ repeats the arguments which were expressed by the Advocate General: the prospective insolvency administrator and the prospective *juge-commissaire* formally have no powers. Therefore, there is no real supervision of a competent public authority.

As a consequence, the Court ruled that employees who are confronted with a pre-pack procedure must be protected *cf.* articles 3 and 4 of Directive 2001/23.

The judgment as a red flag for the Belgian draft legislation on pre-packs?

The question for the Belgian legislator, however, is whether this judgement poses a problem for the draft legislation on pre-packs (Art. XX.34 WER, see my previous post here). I am inclined to say it does.

First of all, the explanatory memorandum ("Memorie van Toelichting"/"Exposé des Motifs") states the following: "*Cet article suit le modèle qui sera également prévu dans la future législation néerlandaise. Il est certain que la finalité d'une telle procédure est de préserver la continuité de l'entreprise ou des activités*" (translated : "This article follows the model that will also be incorporated in the future Dutch legislation. It is certain that the objective of such a procedure is preserving the going concern of the business or the activities"). The ultimate *objective* of the Belgian pre-pack is thus not liquidation, *i.e.* "*maximizing the payment of the creditors' collective claims*". To the contrary: preservation of the business is more than "*a purely functional aspect of that payment*"; It is the goal. As a consequence – although the Belgian legislator thinks otherwise, see here –, the Belgian draft legislation does not pass the first part of the test (*liquidation objective*).

Second, the specific *form* of the pre-pack differs from the form of a "normal" liquidation procedure. Similar to the pre-pack practice in the Netherlands, the Belgian draft legislation stipulates that only the debtor (and thus no other stakeholders, such as creditors) can initiate the pre-pack procedure. Although the Belgian pre-pack procedure would not be informal – since there would be formal legislation –, the prospective insolvency administrator and the prospective *juge-commissaire* would have much less influence than the insolvency administrator and *juge-commissaire* in a traditional liquidation procedure. After all, during the preparatory phase, the debtor (read: the management, controlled by the majority shareholders) stays in control: the debtor asks for a pre-pack procedure, conducts the negotiations, ultimately adopts the necessary decisions and can even fire the prospective insolvency administrator. In the second phase of the pre-pack

procedure, *i.e.* the "normal" liquidation procedure, the prospective insolvency actors become by default – although not always (for my critical reflections on the possible exception, see here) – the "normal" insolvency actors. Since they have to act quickly (to keep the going concern value intact), they will mostly approve the pre-packaged insolvency sale without any further investigation (Note that the ECJ thinks the same, §56-57). After all, the ones who need to be monitored become the monitors… (For my critical reflections on this, see here, here and F. DE LEO, "Ode on a Distant Prospect of Bankruptcy Governance", *De Juristenkrant* 2017, 351, 12-13). For these reasons, I think the Belgian legislator will have a hard time proving they pass the second part of the test (*form of liquidation procedure*).

To conclude, the judgement of the ECJ will have an impact on the Belgian draft legislation concerning the pre-pack. The fact that Directive 2001/23 was not applicable to the pre-pack procedure, was one of its strengths which made the pre-pack attractive. If the employees have to be protected *cf.* Articles 3-4 of Directive 2001/23 in a pre-pack procedure, one could ask himself what the advantages of the pre-pack are compared to the – already existing – Belgian *reorganization* procedure of a transfer under judicial supervision ("*overdracht onder gerechtelijk gezag" / "transfert sous autorité de justice"*). Furthermore, questions can arise as to the conformity of the latter procedure with EU law.

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